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DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 97-0174
Sales Tax
For Tax Periods 1992-1995

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ISSUES

I. Sales Tax—Sale/Leasebacks

Authority: Monarch Beverage Company, Inc. v. Indiana Dept. of Revenue, 589 N.E.2d 1209 (Ind. Tax 1992); IC 6-2.5-5-8; 45 IAC 15-3-2(3); Information Bulletin #42

Taxpayer protests imposition of sales tax on purchase and sale/leaseback of restaurant equipment.

II. Tax Administration—Interest

Authority: IC 6-8.1-10-1

Taxpayer protests imposition of interest on proposed assessments.

III. Tax Administration—Negligence Penalty

Authority: 45 IAC 15-11-2

Taxpayer protests imposition of a ten percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer owns and operates fast food restaurants in Indiana and throughout the country. During the audit period, taxpayer built several restaurants in Indiana and sold the Furniture, Fixtures and Equipment (FF&E) to investors who then leased the FF&E back to taxpayer. The Indiana Department of Revenue (the Department), assessed sales tax on taxpayer's original purchase and on the taxpayer's lease from the financial institutions

which bought the restaurants from taxpayer. Taxpayer believes that only the lease back from the investor is taxable.

I. Sales Tax—Sale/Leasebacks

DISCUSSION

Taxpayer protests the assessment of sales tax on its original purchase of Furniture, Fixtures and Equipment (FF&E) for fast food restaurants it built and operated in Indiana during the audit period. Taxpayer built the restaurants and sold the FF&E to various investors who then leased the equipment back to taxpayer. Taxes were not collected on the sale to the investors per IC 6-2.5-5-8, which states in part:

> Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of his business without changing the form of the property.

Sales taxes were paid when taxpayer leased the property back from the investors. Sales taxes were not collected on the equipment when taxpayer made the original purchases. Taxpayer provided exemption certificates to its suppliers. Taxpayer viewed the purchase and sale/leaseback as one three-way transaction. Taxpayer states that since it always intended to treat these purchases as a sale/leaseback, the initial purchase is not subject to sales tax.

The Department considered the original purchases to be a separate transaction from the sale/leaseback and assessed sales tax on the original purchases. The auditor relied on Monarch Beverage Co., Inc., 589 N.E.2d 1209 (Ind. Tax 1992), which states, "Therefore, sales or use tax can be collected more than once on the same item if the item is the subject of more than one non-exempt retail transaction." Monarch Beverage concerned a beverage distribution company that contracted with a trailer manufacturer to purchase several trailers to transport its products. Monarch ordered the trailers and specified that a third party would pay the manufacturer for the trailers.

When the manufacturer delivered the trailers to Monarch, no third party had been found. Monarch paid the use tax to the Bureau of Motor Vehicles for the trailers, without paying the manufacturer the purchase price, in order to obtain license plates for the trailers. Forty-Six (46) days later, a third party paid the manufacturer the purchase price for the trailers, took title to the trailers, then leased them to Monarch. Sales tax was due on the lease payments and Monarch applied for a refund of the use tax it had paid for the license plates, claiming that it was being taxed twice on the same items. After its protest was denied at the administrative level, Monarch appealed to the Tax Court of Indiana. The Court ruled that two taxable events had occurred. The first was when Monarch had taken possession of the trailers and used them in its business. The second was when Monarch leased the trailers from the third party.

The Department of Revenue viewed the purchase and the leaseback in the instant case as more than one non-exempt retail transaction, since the taxpayer bought the equipment, used it by operating the restaurants, then sold it and leased it back. In the view of the Department, the intent of the taxpayer to treat the three transactions as one three-part transaction was defeated by the fact that taxpayer used the equipment prior to selling it.

Taxpayer refers to several Revenue Rulings issued prior to the Monarch Beverage decision to support its position. Taxpayer states in its protest letter, "While these rulings pre-date the *Monarch Beverage Company, Inc.* case there is no indication that any of these taxpayer favorable rulings have been overturned." The Department refers to 45 IAC 15-3-2(d)(2), which states in part:

> The department may exercise its discretion to retroactively rescind or modify rulings in the following extreme circumstances, which are not all inclusive:
>
> (A) There was a misstatement or omission of material facts.
> (B) The facts, as developed after the ruling, were materially different from the facts on which the department based its ruling.
> (C) *There was a change in the applicable statute, case law or regulation.*
> (D) The taxpayer directly involved in the ruling did not act in good faith.
>
> Taxpayers are cautioned that changes in the law and final decisions of Appellate Court, Supreme Court and Indiana Tax Court cases are notification to the taxpayer of a possible revocation of a ruling, effective from the date of the court decision or change in the law within the statutory open period. (Emphasis added.)

The Monarch Beverage decision was issued on April 7, 1992. The first piece of equipment to have sales tax assessed as a result of the audit was purchased in 1993. Therefore, taxpayer was on notice that the rulings it relied on were superceded prior to its purchase of the FF&E for its restaurants.

Taxpayer believes that its intent to create a single three-way transaction should control how the sales tax is applied. Taxpayer supported this position by pointing out that it always issued exemption certificates to the sellers of the equipment it was purchasing. Taxpayer also provided copies, with its original protest letter, of three documents from the lending institutions it dealt with. Taxpayer explained that these commitment letters show that it intended to sell the restaurant equipment to the lenders before it was purchased, and then lease it back. Of the three documents, two contain no description of the location of the equipment to be purchased by the lender. The other lender, hereafter "Lender One", lists the location for the equipment as "Equipment to be located in no more than four (4) of the Lessee's [Name deleted] franchise locations in the Continental United States." There is no language establishing that the location of the equipment is in Indiana.

The other two documents are not commitment letters. The first of these lenders, hereafter "Lender Two", has a paragraph in its document that states, "The foregoing is a proposal

only and does not constitute a commitment to finance until approved by [Lender Two]'s Credit Committee." The other lender, hereafter "Lender Three", has a paragraph in its document that states, "LESSEE further acknowledges that this proposal is not intended and shall not be construed as a commitment by [Lender Three] and that any commitment is subject to [Lender Three]'s review and written approval."

Also included with the original protest letter was a "Lease Closing Schedule" from Lender Three. This document does list the location of the restaurant concerned, also referred to as "#6367", as being in Indiana. The closing date of the closing schedule is April 20, 1995. The Audit Report shows that the last piece of equipment purchased for unit #6367 occurred on November 30, 1994. This means that there was a difference of one hundred and forty (140) days between the date of the final invoice and the closing date for the lease.

The Department pointed out this 140-day gap between purchase and sale/leaseback to taxpayer in a letter issued at a stage in the administrative process prior to the administrative hearing. Taxpayer responded by providing a copy of another document from Lender Three, dated February 28, 1994, and signed on March 10, 1994 by taxpayer, stating that there was a commitment letter in place at the time of construction for unit #6367.

This document is not a commitment letter. As with the previously discussed letter from Lender Three, there is a paragraph in this document which states, "LESSEE further acknowledges that this proposal is not intended and shall not be construed as a commitment by [Lender Three] and that any commitment is subject to [Lender Three]'s review and written approval." Furthermore, nowhere on this document is there a location or even a unit number provided to establish which restaurant's equipment is being discussed, or even if the location is in Indiana.

Taxpayer protests the "double taxation" of the equipment in question. The Monarch Beverage decision explains that, "Therefore, sales or use tax can be collected more than once on the same item if the item is the subject of more than one non-exempt retail transaction." (Id., at 1214.) The court also explained its reasoning as follows:

> Furthermore, the Legislature intended sales and use taxes as end use taxes imposed on ultimate user/consumers, indicated by providing exemptions that prevent tax pyramiding, *i.e.*, taxing items sold during the intermediate stages of production, prior to completion of the end product:
>
> > 'All sales tax laws exempt or exclude some retail sales. The reasons for this treatment vary. Goods used in the manufacturing process are exempt entirely or partially by all state laws to avoid tax pyramiding, that is, the situation where a tax is levied on a tax and the result is a retail price increase greater than the amount of the tax.'

> *General Motors Corp. v. Indiana Dep't of State Revenue* (1991), Ind. Tax, 578 N.E.2d 399, 405 (quoting *Welsh v. Sells*, 244 Ind. At 434-35, 192 N.E.2d at 759-60).
>
> Monarch is the ultimate user/consumer of the trailers. Taxing the finished trailers more than once therefore does not offend the legislature's policy against tax pyramiding.

Id., at 1214-15

Taxpayer urges the Department to observe the substance over the form of the transactions. Here, the substance of the transactions is that taxpayer bought tangible personal property in a retail transaction and started using it by operating the restaurants. Then, taxpayer sold the property and leased it back from the businesses it sold the property to and used it. This makes the taxpayer the end user in two separate taxable events.

Taxpayer believes that the FF&E should be exempt from the retail sales tax as the original purchase was a sale for resale. Taxpayer states that it always intended to resell the property. The Department refers to 45 IAC 2.2-5-15, which states:

> (a) The state gross retail tax shall not apply to sales of any tangible personal property to a purchaser who purchases the same for the purpose of reselling, renting or leasing, in the regular course of the purchaser's business, such tangible personal property in the form in which it is sold to such purchaser.

This regulation also explains:

> (c)Application of general rule.
>
> (1) The tangible personal property must be sold to a purchaser who makes the purchase with the intention of reselling, renting or leasing the property. *This exemption does not apply to purchasers who intend to consume or use the property or to add value to the property through the rendition of services or performance of work with respect to such property.* (Emphasis added.)

Taxpayer has supplied documentation to establish that the equipment was purchased in the regular course of its business. Subsection (c) of this regulation specifically states that the exemption does not apply to purchasers who intend to use the property. Taxpayer provided documentation to support its position that it was in the business of building and operating restaurants. Taxpayer also explained in its protest letter that there is usually a delay between the completion of a restaurant and its sale to an investor. Therefore, taxpayer did intend to use the property prior to title transferring to the lenders.

Taxpayer refers to Information Bulletin #42, issued in June, 1995, example (5) in the category "OTHER SIMILAR TRANSACTIONS SUBJECT TO SALES TAX", which

lists, "Tangible personal property initially purchased for a nonexempt purpose and subsequently used as rental property." Taxpayer believes that since its intention was to treat the purchases as a sale/leaseback, the initial purchases were for an exempt purpose, therefore example (5) does not apply and those purchases were not subject to sales tax.

Information Bulletin #42 deals with sales tax as it applies to rental and leasing of tangible personal property. The introduction of the Information Bulletin states:

> A lessor engaged in the business of renting or leasing tangible personal property in Indiana must register as a retail merchant with the Indiana Department of Revenue. Every lessor is required to collect and remit the Indiana gross retail tax (5%) on the price of the rental or lease contract.

Taxpayer is the lessee in the sale/leaseback, not the lessor. The various lenders taxpayer sold the equipment to are the lessors. Taxpayer stated in its protest letter and at hearing that it believes that the leaseback of the property is taxable. Example (5) concerns the purchases by the lessors (lenders), not the lessee (taxpayer). From the perspective of the lenders, the property was used as rental property, and therefore properly subject to sales tax when leased.

To conclude, while taxpayer may have intended to conduct a single transaction with three steps, the result is that three transactions took place. The first was the initial purchase and use of the equipment, which is a taxable transaction. The second was the sale of the equipment to the various lenders. The lenders purchased the equipment in order to rent it, therefore this transaction is exempt. The third transaction was the equipment rental by the purchasers (lessor) to taxpayer (lessee), which is a second taxable transaction.

FINDING

Taxpayer's protest is denied.

II. Tax Administration—Interest

Taxpayer protests the imposition of interest on the amount assessed in the audit. IC 6-8.1-10-1(a) provides:

> If a person fails to file a return for any of the listed taxes, fails to pay the full amount of tax shown on his return by the due date for the return or the payment, or incurs a deficiency upon a determination by the department, the person is subject to interest on the nonpayment.

IC 6-8.1-10-1(e) establishes that the Department may not waive the interest imposed under this section. Therefore, the interest may not be waived.

FINDING

Taxpayer's protest is denied.

III. Tax Administration—Negligence Penalty

Taxpayer protests imposition of a ten percent (10%) negligence penalty. Taxpayer states that it makes every attempt to collect, self-assess and remit the proper amount of sales and use taxes due, and has implemented numerous procedures to be in compliance. Taxpayer also believes that it acted in a prudent manner and that the resulting liabilities result from either taxpayer's interpretation of the tax codes or an oversight.

The relevant regulation is 45 IAC 15-11-2(c), which states in part:

> The department shall waive the negligence penalty imposed under [IC 6-8.1-10-2.1] if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, taxpayer has demonstrated that it exercised ordinary business care and prudence in carrying out its duty to pay sales tax. Therefore, taxpayer has affirmatively established reasonable cause, and the negligence penalty shall be waived.

FINDING

Taxpayer's protest is sustained.

WL/PE/MR 000408